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In The

Supreme Court of the United States

DIAMOND MULTIMEDIA SYSTEMS, INC., WILLIAM J. SCHROEDER, GARY B. FILLER AND HYUNG HWE HUH,

Petitioners,

v.

SUPERIOR COURT OF SANTA CLARA COUNTY (*PASS*),

Respondent.

On Petition For A Writ Of Certiorari To The Supreme Court Of The State Of California

BRIEF FOR *AMICI CURIAE*, THE SECURITIES INDUSTRY ASSOCIATION, THE NATIONAL VENTURE CAPITAL ASSOCIATION AND THE AMERICAN ELECTRONICS ASSOCIATION IN SUPPORT OF PETITIONERS

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I. STATEMENT OF INTEREST[1]

The Securities Industry Association (the "SIA"), the National Venture Capital Association (the "NVCA") and the American Electronics Association (the "AEA") hereby respectfully submit this Amici Curiae Brief in support of Petitioners Diamond Multimedia Systems, Inc., William J. Schroeder, Gary B. Filler and Hyung Hwe Huh. Pursuant to Rule 37.2 of this Court, both parties have consented to the filing of this brief.

Amici curiae together represent more than 4,000 companies and firms whose interests will be directly affected by the outcome of this case. Representing more than 760 securities firms, including investment banks, broker dealers and mutual fund companies, the SIA speaks for the backbone of the securities industry throughout the United States. The NVCA's over 240-member venture capital firms provide significant venture capital funding, including more than 80% of the approximately $10 billion in professional venture capital raised for emerging growth companies in 1996. The AEA's 3000 member companies span the length and breadth of the high-technology industry that is driving job growth and capital formation in California and throughout the country.

Amici curiae are keenly interested in ensuring the cohesive and predictable regulation of the nation's capital markets. The California Supreme Court's ruling in this case has resulted in overlap between state and federal securities regulation, as well as sanctioning the wholesale evasion of the Reform Act's procedural and substantive safeguards against abusive litigation. Accordingly, the ruling significantly impacts the members of the *amici curiae*.

II. REASONS FOR GRANTING REVIEW

The California Supreme Court's decision in *Diamond Multimedia* interpreted California Corporations Code Section

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[1] Pursuant to Rule 37.6, it is affirmed that counsel for *amici curiae* authored this brief, and that no person or entity other than *amici curiae* and its counsel made a monetary contribution to the preparation or submission of this brief.

25400 to have broad extraterritorial effect in contravention of Congressional intent and the federal scheme of regulating national securities markets. *Diamond Multimedia Systems, Inc., v. Superior Court*, 19 Cal. 4th 1036 (1999). Under the California Court's reasoning, Section 25400 is permitted to impose liability on a defendant, who may have contacts entirely outside of California, provided only that a false statement is made or "willfully disseminated" in California. *Id.* at 1051. In today's financial marketplace, where information is transmitted around the world at the speed of the internet or CNN, the notion that 'willful dissemination' is a meaningful limitation on the extraterritorial reach of Section 25400 fails. "[C]ompanies with publicly-traded securities cannot choose to avoid jurisdictions which present unreasonable litigation costs. Thus, a single state can impose the risks and costs of its peculiar litigation system on all national issuers." S. Rep. No. 182, 105th Cong., 2nd Sess. (July 27, 1998). Such prognostication has here become reality.

For example, under the California Court's decision, a New York resident who purchased stock in New York from a New York seller, through a New York broker, over the New York Stock Exchange, and who has no contacts with California, would be covered by Section 25400 (and included in a nationwide class consisting of many thousands of nonresidents who purchased stock under similar circumstances) if:

(1) He had invested in a California company;

(2) A non-California representative of a non-California company made an allegedly misleading statement during an industry conference in California;

(3) A non-California representative of a non-California underwriter or issuer made an allegedly misleading statement during a California stop on a nationwide "road show" in connection with an initial public offering;

(4) A statement made outside of California by a non-California representative of a non-California company was reported in California (and throughout the United States) by *The Wall Street Journal* or another national newspaper;

(5) A statement placed by a non-California company on its internet site was accessed on the worldwide web in California.

The present lawsuit exemplifies both the conflict between the California statute and the Reform Act, and the constitutional infirmity permitting application of that statute to securities transactions throughout the United States. That point is well-illustrated here; while the federal action has not progressed past the pleading stages and no discovery has been taken, Petitioners have been subject to discovery in the California courts. *See* Petition for Writ of Certiorari of Diamond Multimedia Systems, Inc., at 19. In the Reform Act, Congress took the unusual step of staying discovery until a case could survive a motion to dismiss. The provision's express purpose was to enable companies to avoid the massive and potentially bankrupting costs of discovery until there was a viable case, and not a 'strike suit,' in the courts. However, since passage of the Reform Act, plaintiffs' lawyers have sought to circumvent the Act's provisions by filing lawsuits in state court, where none of the Reform Act's procedural or substantive protections against abusive suits are available. H.R. Conf. Rep. No. 803, 105th Cong., 2nd Sess. (May 19, 1998).

As a result of these tactics, the number of state securities cases has skyrocketed post-Reform. One study, by Price Waterhouse, LLP, found that the average number of parallel and 'federal equivalent' securities class actions filed in state court during 1996 was 355% over the 1991-1995 average.[2] Although there was a drop in the number of these state court filings in 1997, the number of state cases that year nonetheless was 150% higher than the 1991-1995 average. H.R. Conf. Rep. No. 640, 105th Cong. 2nd Sess., n.9 (July 21, 1998). The Plaintiffs'

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[2] Before the Reform Act, there was no significant state securities class actions. *See* 19 Cal. 4th at 1069, citing Grundfest, Joseph A. & Perino, Michael A., *Securities Litigation Reform: The First Year's Experience: A Statistical and Legal Analysis of Class Action Securities Fraud Litigation under the Private Securities Litigation Reform Act of 1995* n.18; Conf. Reg. No. 640, 105th Cong., 2nd Sess. (July 21, 1998), Stanford Law School (February 27, 1997).

migration to state court bar has obviated the core objectives of the Reform Act.

As a means of stopping these types of lawsuits and reaffirming its intent to reform securities litigation, Congress passed the Securities Litigation Uniform Standards Act of 1998 Pub. L. No. 105-353 ("Uniform Standards Act") with unusual speed. The Uniform Standards Act makes federal court and federal law the exclusive regime for most large-scale securities class actions. 15 U.S.C. § 77p; 15 U.S.C. § 78bb. Unfortunately, in their rush to foreclose state securities class actions, Congress has enacted what is only a limited solution to the problem. Despite preemption by Congress, certain well-defined loopholes in the Act make it possible that state securities actions will persist. For example, derivative actions are excluded. *Id.* In addition, a class action is only defined as any action brought on behalf of 50 or more investors, so that individuals may still bring state securities actions that avoid the Reform Act's most important provisions. *Id.*

In large part, the partial remediation of the problem of state court securities litigation by the Uniform Standards Act derived from the belief that, in accordance with accepted principles of constitutional law, states would not interpret their securities statutes to have nationwide effect. Indeed, opponents of the bill cited to a slowdown in the number of cases being filed in state court as evidence that the rush to avoid the Reform's Acts provisions was largely unsuccessful. S. Rep. No. 182, 105th Cong., 2nd Sess. (May 4, 1998). State court litigation was thought to have died shortly before the passage of the Uniform Standards Act; *mainly because it was presumed that California would not become the plaintiffs' lawyer mecca for state court securities claims due to the limited reach of California state securities law claims. Id.* Unfortunately, the California Supreme Court's opinion in *Diamond Multimedia* provides otherwise.

The ruling by the California Supreme Court in *Diamond Multimedia* indicates that the proper balance between state and federal securities litigation has yet to be achieved. It is equally apparent that a definitive determination of the constitutional

parameters of state securities regulation is now necessary in order to obtain such balance. As articulated by the dissent below, absent a clear demarcation of the Constitutional limits placed upon state securities regulation, "the effect of the Congress' passage of the Reform Act will be to offer securities plaintiffs and their class counsel a 'safe harbor' from which to evade the effects of the Reform Act." 19 Cal. 4th at 1070. Neither the intent underlying Congressional regulation of securities transactions, nor the principles of federalism permit such an unseemly result.

III. THE NATIONWIDE SCOPE OF CALIFORNIA'S SECTION 25400 CONFLICTS WITH THE FEDERAL SCHEME OF SECURITIES REGULATION, AND THEREFORE IS PREEMPTED

Prior to the Reform Act's December 1995 enactment, state courts were rarely called upon to apply the blue sky law antifraud provisions (such as California's Section 25400)[3] to out-of-state securities transactions. Accordingly, the issue of whether such laws were preempted by federal law was not raised. That was no doubt because, prior to the Reform Act's passage, there was no clear, fundamental conflict between the blue sky laws of California, or any other state, and the federal securities laws.

With the passage of the Reform Act, however, the antifraud provisions of California's securities laws are now indisputably in conflict with federal law.[4] The starkest of these

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[3] Courts have historically simply assumed that California's Blue Sky laws only reach intrastate activity and, therefore, present no preemption issue. *See, e.g., Sullivan v. First Affiliated Securities, Inc.*, 813 F.2d 1368, 1373 (9th Cir.), *cert. denied*, 484 U.S. 850 (1987) ("federal securities laws do not preempt state securities laws that regulate intrastate offerings of securities and affect interstate commerce only incidentally").

[4] The fact that California's antifraud statutes prohibit conduct that the federal securities laws now immunize is confirmed by the dramatic increase in the number of securities fraud class actions filed in state court

conflicts involves the Reform Act's Safe Harbor provisions. This substantive conflict becomes a constitutional conflict upon the expansion of California's Section 25400 into the national securities regulatory structure which the Reform Act is intended to govern exclusively. Because California's Section 25400 now directly conflicts with federal law, it is preempted.

1. California's Section 25400 Stands as an Obstacle to the Accomplishment of the Reform Act's National Purposes

Federal law may preempt state law either expressly or by implication.[5] As explained in *Barnett Bank*, preemption will be found when:

> a federal statute . . . create[s] a scheme of federal regulation "so pervasive as to make reasonable the inference that Congress left no room for the States to supplement it." *Alternatively, federal law may be in "irreconcilable conflict" with state law*. Compliance with both statutes, for example, may be a "physical impossibility," *or, the state law may "stand as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress*."

Barnett Bank of Marion County v. Nelson, 1517 U.S. 25, 31 (1996) (citations omitted; emphasis added). Here California's

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coinciding with the passage of the Reform Act. As the dissent recognized, a recent study has confirmed that the plaintiffs' securities class action bar has migrated from federal to state court to evade the Reform Act's litigation hurdles. 19 Cal. 4th at 1069-70.

[5] The preemption doctrine derives from the Supremacy Clause of the United States Constitution, which provides that federal laws "shall be the supreme Law of the Land . . . any Thing in the Constitution or Laws of any State to the Contrary notwithstanding." United States Constitution, Article VI, clause 2. By this language, Congress is vested with the power to supersede state statutory, regulatory and common law. *See, e.g., Freightliner Corp. v. Myrick*, 514 U.S. 280 (1995); *International Paper Co. v. Ouellette*, 479 U.S. 481, 496 (1987).

Section 25400 clearly "stand[s] as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress" as set forth in the Reform Act. *See Hines v. Davidowitz*, 312 U.S. 52, 67 (1941). Given the nationwide application of California's Section 25400, there can be no doubt that an "irreconcilable conflict" now exists.

a. The Purpose of the Reform Act

The Reform Act governs private securities actions, such as this one, that are brought in federal court. Under the Reform Act's Safe Harbor provisions,[6] forecasts, and other so-called forward-looking statements are not actionable if they are accompanied by meaningful cautionary statements identifying important factors that could cause actual results to vary. 15 U.S.C. § 77z-2. The Reform Act also immunizes forward-looking statements, even when not accompanied by cautionary language, if there is no proof that the statements were made with actual knowledge of their falsity. *Id.*

In overriding President Clinton's veto and adopting the Reform Act, Congress sought to "protect investors, issuers, and all who are associated with our capital markets from abusive securities litigation" and recognized that "[a]busive litigation severely affects the willingness of corporate managers to disclose information to the marketplace." H.R. Conf. Rep. No. 369, 104th Cong., 1st Sess. 32, 42 (1995). In the words of the Conference Committee:

> *Understanding a company's own assessment of its future potential would be among the most valuable information shareholders and potential investors could have about a firm.* [¶] . . . *The Conference Committee intends the statutory safe harbor protection to make more information about a company's future plans available to investors and the public.*

Id. at 43, 45 (emphasis added).

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[6] The Safe Harbor for forward-looking statements is set forth in 15 U.S.C. § 77z-2, 15 U.S.C. § 78u-5.

b. The Muzzling Effect of California's Section 25400

California's Section 25400 provides no Safe Harbor and its application on a nationwide basis results in the very "muzzling" of corporate management that federal law now eliminates. Forward-looking statements containing precisely the kind of meaningful cautionary statements specified, encouraged and statutorily *immunized* in the Reform Act may still be deemed "unlawful" under Section 25400.

While it is doubtful that claims based on such forward-looking statements would even be brought in federal court today, if they were, they would in all probability not survive a motion to dismiss. *See, e.g., Harris v. Ivax*, 998 F. Supp. 1449 (S.D. Fla. 1998). As the *Diamond* case shows, however, such claims are now pled on a nationwide scale, and routinely survive demurrers in California Court. Under these circumstances, a company such as Petitioner Diamond Multimedia will not be able "to discuss publicly its future prospects," as Congress intended, for fear that it will be sued under Section 25400. The majority opinion below fundamentally ignored this result by incorrectly interpreting the Reform Act's Safe Harbor "actual knowledge" standard as essentially identical to Section 25400's substantive standards. However, this interpretation ignores the fact that the Safe Harbor precludes *any* liability for a statement accompanied by cautionary language and runs roughshod over the intent of Congress to immunize defendants from liability when they accompany their forward-looking statements with meaningful cautionary language.[7] As a matter of constitutional law, nationwide application of Section 25400 unquestionably "stand[s] as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress,"

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[7] As a matter of plain statutory interpretation, the California Supreme Court erred in holding that no Safe Harbor immunity exists as long as a plaintiff demonstrates forward-looking statements were made with "actual knowledge." *See* 19 Cal. 4th at 1057 (stating that the Safe Harbor does not attach where cautionary language is omitted "and/or" statements are made with actual knowledge of falsity).

Barnett, 517 U.S. at 31. The statute is, thus, in "irreconcilable conflict" with federal law.

2. In Direct Conflict with the Decision Below, Other State Courts Have Acknowledged Preemption Under Similar Circumstances

The highest courts of New York, Minnesota and Illinois have ruled that portions of their states securities laws are preempted by the federal scheme. *Guice v. Charles Schwab & Co., Inc.*, 89 N.Y. 2d 31 (N.Y. 1996), *cert. denied*, 520 U.S. 1118 (1997); *Dahl v. Charles Schwab & Co., Inc.*, 545 N.W.2d 918 (Minn. 1996), *cert. denied*, 519 U.S. 866 (1997); *Orman v. Charles Schwab & Co., Inc.*, 179 Ill. 2d 282 (1997).[8] The facts in these cases are substantially similar,[9] leading the dissent below to acknowledge that "[they are] not only compelling, they point to the same conclusion." 19 Cal. 4th at 1071.

The *Guice* court determined that New York's law was preempted for two reasons that are particularly relevant here. *First*, if New York (and other states) imposed liability for failure to meet state-law standards stricter than those mandated by Congress and the SEC, brokers would have to tailor their disclosures to satisfy each state's laws, which "would inevitably defeat the congressional purpose of enabling the SEC to

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[8] Courts in at least four other states have reached the same conclusion in cases involving similar facts. *McKey v. Charles Schwab & Co., Inc.*, Case No. BC139314, Los Angeles County Superior Court (1996); *Gilman v. BHC Securities, Inc.* [1995-1996 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,051 (S.D.N.Y. Dec. 18, 1995), *vacated on other grounds*, 104 F.3d 1418 (2d Cir. 1997); *Eirman v. Olde Discount Corp.* 697 So. 2d 865 (Fla. App. 1997).

[9] In each case, the defendant securities brokers effectuated trades through market makers who returned part of their profit to the brokers in "order flow payments." The defendant brokers retained these payments and after each transaction, sent a confirmation slip to the customer, which did *not* include any information concerning the payments. Plaintiffs sued for, breach of fiduciary duty and fraud (among other claims), alleging that the brokers were under a state law duty to disclose the payments.

develop and police that 'coherent regulatory structure' for a national market system." *Guice*, 89 N.Y.2d at 46. Accordingly, the resulting "deleterious if not ruinous effects" upon Congressional policy were "alone sufficient to require preemption." *Id.* at 48.

Second, enforcement of New York's common law would thwart Congress' will by:

> interfer[ing] with the *methods* by which the federal statute was designed to reach this goal . . . [i]t would be extraordinary for Congress, after devising an elaborate [balanced regulatory] system that sets clear standards, to tolerate common-law suits that have the potential to undermine this regulatory structure."

Guice, 89 N.Y.2d at 48-49 (quoting *International Paper Co. v. Oullette*, 479 U.S. 481, 494, 497 (1987) (emphasis added)).[10]

Thus, *Guice* looked to the legislative history of the 1934 Act amendments, identified Congress' objective,[11] and concluded that applying New York law would (1) "defeat the congressional purpose" and (2) result in the elimination of the practice the amendments sought to encourage. Application of this analysis leads to precisely the same result here because

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[10] *Dahl* reached the same conclusion for largely the same reasons, noting that, "the objectives of the SEC and Congress" were frustrated. 545 N.W.2d at 925 (emphasis added). In language that is directly applicable here, the Minnesota Supreme Court emphasized the need for uniformity in the nation's securities laws:

> given the complicated and intricate nature of the securities industry, anything affecting a practice as widely utilized as this one *will have a significant impact on the securities markets nationwide*. Whether this impact will be positive or negative is not for this court to judge. It is sufficient for us to identify the national import and possible effect of our decision and recognize that decisions with such a reach are for the SEC and Congress.

Id. at 925-26 (emphasis added).

[11] *Orman* engaged in an identical analysis by relying on the "purpose and objective" of the Reform Act as derived from its "history and evolution." 688 N.E. 2d at 622.

Congress' specific purpose in enacting the Safe Harbor was to encourage corporate managers to "discuss publicly their future prospects" without fear of securities lawsuits. Nationwide application of California Section 25400 defeats that purpose, by penalizing and inhibiting forward-looking statements that the Reform Act immunizes. As the SEC found, corporations are still "reluctant to provide significantly more forward-looking disclosure beyond what they provided prior to enactment of the safe harbor [because they are] concerned about . . . potential liability under state law." Report to the President and Congress on the First Year of Practice Under the Private Securities Litigation Reform Act of 1995 (April 1997) at 25. Moreover, as the *Dahl* court found, interstate enforcement of California Section 25400 would affect a "widely utilized" practice public discussion of a company's future prospects, "have a significant impact on the securities markets nationwide" and are for the SEC and Congress. *Dahl*, 545 N.W.2d at 925-26.

3. California's Section 25400 Is Inconsistent with Established Authority Regarding Preemption Under the 1934 Act

In a line of cases beginning with *Edgar v. MITE*, 457 U.S. 624 (1982), numerous federal courts[12] have held that state anti-takeover laws are preempted by portions of Sections 13 and 14 of the 1934 Act (the "Williams Act").[13] In *Edgar*, the Court found that the Illinois law conflicted with and was preempted by the Williams Act because it impermissibly interfered with "the *careful balance* struck by Congress and . . . therefore st[ood] as obstacles to the

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[12] *See, e.g., Hyde Park Partners, L.P. v. Connolly*, 839 F.2d 837, 852 (1st Cir. 1988); *Great Western United Corp. v. Kidwell*, 577 F.2d 1256, 1280 (5th Cir. 1978), *rev'd on other grounds sub nom, Leroy v. Great Western United Corp.*, 443 U.S. 173 (1979); *National City Lines, Inc. v. LLC Corp.*, 687 F.2d 1122 (8th Cir. 1982); *see also Kennecott Corp. v. Smith*, 637 F.2d 181 (3d Cir. 1980); *L.P. Acquisition Co. v. Tyson*, 772 F.2d 201 (6th Cir. 1985).

[13] The Williams Act, which regulates tender offers and takeover bids, is codified at 15 U.S.C. §§ 78m(d)-(e) and 78n(d)-(f), corresponding to Sections 13(d) and (e) and 14(d)-(f) of the 1934 Act.

accomplishment and execution of the full purposes and objectives of Congress." *Id.* at 634 (emphasis added). The nationwide application of California Section 25400 leads to the same result. The Reform Act, like the Williams Act, represents a careful balance struck by Congress which would be interfered with and neutralized by national class actions brought in California courts pursuant to Section 25400.

4. Savings Clauses Do Not Permit Conflicting State Statutes

Both the 1933 and the 1934 Acts contain "savings clauses" permitting states to regulate in the field of securities.[14] The cornerstone of the majority opinion's deferral of the preemption issue rested upon the 1934 Act's savings clause. 19 Cal. 4th at 1060. It is now well established, however, that these provisions do not permit the enforcement of state laws that actually conflict with or pose an obstacle to federal law.

First, savings clauses negate only implied *field* preemption – *i.e.*, they are a Congressional expression that it did not intend to occupy the entire field of the legislation in question, thereby preventing the states from legislating in that area altogether. *Edgar*, 457 U.S. at 631 (notwithstanding 1934 Act savings clause, "[a] state statute is void to [the] extent that it actually conflicts with valid federal statute"); *Gilman*, [1995-1996 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 94,245-56 ("[1934 Act savings clause] does not mitigate the force of conflict preemption").[15]

Savings clauses, therefore, do not negate implied *conflict* preemption – *i.e.*, they do not allow states to legislate in ways that actually conflict with the federal legislation. Indeed, the 1934 Act's savings clause makes this point expressly:

> nothing in this Act shall affect the jurisdiction of the securities commission . . . of any State over any security

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[14] 15 U.S.C. § 77p; 15 U.S.C. § 78bb.

[15] *See also Gade v. National Solid Wastes Management Ass'n*, 505 U.S. 88, 108 (1992) ("under the Supremacy Clause, . . . any state law, however clearly within a state's acknowledged power, which interferes with or is contrary to federal law, must yield").

> or any person *insofar as it does not conflict with the provisions of this Act or the rules and regulations thereunder.*

Sec. 28(a), 15 U.S.C. § 77bb (emphasis added).

Second, the majority opinion's contention that Congress' express preemption for certain types of securities actions in the Uniform Standards Act, "confirm[s] "all other actions under state law is erroneous." 19 Cal. 4th at 1046, n.12. This is directly contrary to *Freightliner,* 514 U.S. 280 (1995), which holds that the existence of express statutory preemption does not obviate the need for analysis of an individual statute's preemptive effects. *Id.* at 287-89.

In the present case, any possible inference negating an implied preemption has been eliminated because the nationwide scope of California Section 25400 not only has "the potential," but does, in fact, actually "undermine [Congress'] regulatory structure." *International Paper Co.*, 479 U.S. at 497. Accordingly, neither Acts' savings clauses prevent Section 25400 from being preempted.

IV. NATIONWIDE APPLICATION OF CALIFORNIA SECTION 25400 VIOLATES THE COMMERCE CLAUSE

The majority opinion below also directly challenges this Court's commerce clause jurisprudence by stating that California Section 25400 regulates securities transactions both in California and "throughout the country." 19 Cal. 4th at 1063-64. Such a construction violates the Commerce Clause of the United States Constitution, which limits the power of individual states to adopt legislation that impacts other states' autonomy or interstate commerce.[16] *Edgar,* 457 U.S. at 640; *see also Healy v. Beer Institute, Inc.*, 491 U.S. 324, 335-36, 337 n.14 (1989).

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[16] *See* United States Constitution, Article I, § 8 (Commerce Clause). The Commerce Clause tightly restricts states' ability to enact statutes which regulate interstate commerce because of "the Constitution's special concern with . . . the autonomy of the individual States within their respective spheres." *Healy*, 491 U.S. at 335-36. It does so because " '[i]t would be impossible to permit the statutes of [a state] to operate beyond the jurisdiction of that State . . . without throwing down the constitutional

Under this Court's "two-tier approach" towards analyzing whether statutes pass muster under the Commerce Clause,[17] a state statute violates the Commerce Clause if it regulates interstate commerce or imposes one state's policies upon a sister state either directly or indirectly. *Edgar*, 457 U.S. at 643; *Healy*, 491 U.S. at 337 n.14; *Brown-Forman Distillers*, 476 U.S. at 579. By giving Section 25400 a nationwide scope, and allowing it to govern securities transactions made outside California, the California Supreme Court has allowed California's Blue Sky laws to regulate interstate commerce (and impose burdens on other states) both directly and indirectly. Accordingly, the statute violates the Commerce Clause.

1. California Section 25400 Violates the Commerce Clause by Allowing California to Directly Regulate Non-Intrastate Transactions

The majority opinion below asserts that no constitutional infirmity is present because Section 25400 "regulates only manipulative conduct in California. It does not purport to regulate any 'transactions' in securities which occur outside of this state." 19 Cal. 4th at 1062. As demonstrated above, this rationalization does not comport with the factual reality of modern day capital markets. More importantly, it runs afoul of this Court's established principles for evaluating the impact of state action on interstate commerce. Consequently, as demonstrated below, the California Supreme Court's pronunciation that Section 25400 does not regulate non-California securities transactions is erroneous as a matter of constitutional law.

In *Healy*, this Court reviewed prior cases addressing "the extraterritorial effects of state economic regulation" and summarized the manner in which the Commerce Clause limits a state's

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barriers by which all the States are restricted. . . . ' " *BMW of North America, Inc. v. Gore*, 517 U.S. 559, 572, n.16 (1996) (quoting *New York Life Ins. Co. v. Head*, 234 U.S. 149 (1914)).

[17] *Healy*, 491 U.S. at 337 n.14; *Brown-Forman Distillers Corp. v. New York State Liquor Authority*, 476 U.S. 573, 578-79 (1986); *see also Edgar*, 457 U.S. at 643.

ability to *directly* regulate interstate commerce. A statute violates the Commerce Clause by directly regulating interstate commerce if:

(1) the statute applies to "commerce that takes place wholly outside of the State's borders, *whether or not the commerce has effects within the State*";

(2) the statute "directly controls commerce occurring wholly outside the boundaries of a State . . . regardless of whether the statute's extraterritorial reach was intended by the Legislature. The *critical inquiry* is whether the *practical effect of the regulation* is to *control conduct beyond the boundaries of the State*"; or

(3) the statute's *"practical effect" is to produce "inconsistent legislation* arising from the projection of one state['s] regulatory regime into the jurisdiction of another State."

Healy, 491 U.S. at 336-37 (emphasis added); *see also Edgar*, 457 U.S. at 642.[18] As it stands, Section 25400 directly regulates interstate commerce in *each* of these three unconstitutional ways.

a. California Section 25400 Regulates Commerce Occurring Outside California

As set forth by the majority, California's Section 25400's territorial scope is governed by the question of whether a "statement is made by a person in California or *is willfully disseminated in California*." 19 Cal. 4th at 1051 (emphasis added). As a mere

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[18] A state's Blue Sky laws must comply with the Commerce Clause even though section 28(a) of the 1934 Act explicitly allows states to regulate securities transactions. *See, e.g., Edgar*, 457 U.S. at 641 (discussing Blue Sky laws and the Commerce Clause); *CTS Corp. v. Dynamics Corp. of America*, 481 U.S. 69, 80 (1987) (discussing Indiana's Blue Sky law's compliance with the Commerce Clause); *North Star Int'l v. Arizona Corp. Comm'n*, 720 F.2d 578, 583 (9th Cir. 1983); *Arizona Corp. Comm'n v. Media Products, Inc.*, 158 Ariz. 463, 467 (Ariz. Ct. App. 1988); *State ex rel. Corbin v. Goodrich*, 151 Ariz. 118, 122 (Ariz. Ct. App. 1986) (all reviewing Arizona's Blue Sky law's compliance with the Commerce Clause).

practical matter, premising liability on a standard of "willful dissemination" in California effectively ensures that all statements made in connection with a nationally traded security will face potential liability under Section 25400. As a matter of constitutional jurisprudence, such a construction violates the Commerce Clause.

A state statute directly regulates interstate commerce in violation of the Commerce Clause if it applies "to commerce that takes place wholly outside of the State's borders, *whether or not the commerce has effects within the State*." *Edgar*, 457 U.S. at 642-43 (striking Illinois' Blue Sky law regulating interstate transactions made across state lines between corporation and non-resident shareholders) (emphasis added); *see also Healy*, 491 U.S. at 336. When a statute directly regulates interstate commerce in this manner, it must be stricken because " 'any attempt 'directly' to assert extraterritorial jurisdiction over persons or property would offend sister States and exceed the inherent limits of the State's power.' " *Edgar*, 457 U.S. at 643 (quoting *Shaffer v. Heitner*, 433 U.S. 186, 197 (1977)).

Whether a statute violates the Commerce Clause depends on its territorial scope. Blue Sky laws pass constitutional muster when they "apply to dispositions of securities within the State. . . . " *Edgar*, 457 U.S. at 641. They are *un*constitutional, however, if they "regulate[ ] transactions which take place across state lines" and thus "*could* be applied to regulate a [transaction] which would not affect a single . . . shareholder [from the regulating state]." *Id.* at 641, 642 (emphasis added); *Brown-Forman Distillers*, 476 U.S. at 580 (regulation of the out-of-state transactions of corporations who also sell in-state violates Commerce Clause). Under this standard, a statute that regulates the sales of securities in other states, or regulates purchasers in other states, conflicts with the Commerce Clause.[19] While there are many instances where states

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[19] *See, e.g., Terry v. Yamashita*, 643 F. Supp. 161, 165 (D. Haw. 1986) (Hawaii's control acquisition statute, which can be applied to regulate purchases even when no shareholder is a resident of the regulating state" and, therefore, has an extraterritorial effect, comprises a direct burden on interstate commerce and is invalid); *Media Products, Inc.*, 158 Ariz. at 464,

appropriately regulate intrastate securities transactions,[20] none are as dramatically expansive as the California Supreme Court's grant of nationwide scope to Section 25400, nor is the actuality of nationwide application so plainly apparent.

As interpreted by the California Supreme Court, Section 25400 regulates purchases and sales of securities that take place outside California, even when made to non-California residents. Such regulation impermissibly interferes with interstate commerce both by regulating transactions made wholly outside California, and by regulating transactions made by non-California residents. *See, e.g., Media Products, Inc.*, 158 Ariz. at 464, 467, 469; *Corbin*, 151 Ariz. at 122. Pursuant to established commerce clause principles, the California Legislature is not permitted to determine what constitutes securities fraud in connection with securities transactions made in other states.

b. California Section 25400 Controls Conduct Beyond California's Boundaries

A state statute also violates the Commerce Clause by directly regulating interstate commerce if it has "the practical effect of . . . controll[ing] conduct beyond the boundaries of the [regulating] State." *Healy*, 491 U.S. at 336. Thus, a statute will be stricken

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467, 469 (Arizona's Blue Sky law is unconstitutional as "improper interference with interstate commerce" because it regulates non-residents' purchases from an out-of-state corporation that has its principal place of business in Arizona); *Corbin*, 151 Ariz. at 122 (if Arizona's securities fraud statute "sought to regulate the sale of securities outside Arizona, it would conflict with the Commerce Clause and would be unconstitutional;" statute upheld because it only regulates sales occurring in Arizona).

[20] *See CTS Corp.*, 481 U.S. at 80, 93 (Indiana statute does not violate Commerce Clause because it applies only to corporations incorporated within Indiana and "every application . . . will affect a substantial number of Indiana residents"); *Enntex Oil & Gas Co. v. State*, 560 S.W.2d 494, 497 (Tex. Cir. App. 1977) (Texas Securities Act does not violate the Commerce Clause because it only applies to transactions in Texas); *Haberman v. Washington Public Power Supply System*, 109 Wash. 2d 107, 134-36 (Wash. 1987) (Washington Securities Act does not violate Commerce Clause when applied to bonds issued in Washington).

when it "control[s] commercial activity occurring wholly outside the boundary of the State." *Id.* at 337. Statutes unconstitutionally regulate a corporation's conduct when they tie a corporation's ability to comply with the regulating state's rules to the corporation's conduct in other, non-regulating states. *Id.* at 338 (unconstitutional to require a seller to affirm that its price in regulating state is no higher than its lowest price elsewhere because this prevents the seller from changing its price elsewhere); *accord Brown-Forman Distillers*, 476 U.S. at 581-82. Such statutes are also unconstitutional when they deprive corporations of "whatever competitive advantages they may possess" in another state. *Healy*, 491 U.S. at 338, (quoting *Brown-Forman Distillers Corp. v. New York State Liquor Authority*, 476 U.S. 573, 580 (1986)).

California Section 25400 has the practical effect of making corporations monitor and limit their conduct *nationwide* to avoid the prospect of liability under California law. It also causes corporations to lose "whatever competitive advantage" they gain by conducting securities transactions in a state whose securities laws differ from those in California. This is plainly evident from the California Supreme Court's express interpretation of the statute which states that Section 25400's primary purpose is to address "fraudulent practices in this state which may have an *effect both in California and throughout the country*." 19 Cal. 4th at 1063. Given that Section 25400 encompasses non-California transactions, no local California interest, no matter how availing is sufficient to remedy its unconstitutionality.

> [A] State has *no legitimate interest in protecting nonresident shareholders*. Insofar as the . . . law burdens out-of-state transactions there is nothing to be weighed in the balance to sustain the law.

Edgar, 457 U.S. at 644 (emphasis added); *see also Terry*, 643 F. Supp. at 166 ("Hawaii has no legitimate interest in protecting nonresident stockholders").

c. California Section 25400 Has the Practical Effect of Producing Inconsistent Legislation

Finally, a state statute violates the Commerce Clause by directly regulating interstate commerce if it has the "practical

effect" of creating "inconsistent legislation" by "project[ing] . . . one state['s] regulatory regime into the jurisdiction of another State." *Healy*, 491 U.S. at 336; *Brown-Forman Distillers*, 476 U.S. at 583-84; *CTS Corp.*, 481 U.S at 88-89.

California Section 25400 regulates securities transactions made outside California, even though such transactions would *also* be simultaneously governed by another state's Blue Sky laws. Because the laws of numerous other states have requirements for pursuing securities fraud actions that differ from, and are inconsistent with, California Section 25400, such a construction would subject corporations to "inconsistent obligations" from different states for the same transaction.[21] *See Brown-Forman Distillers*, 476 U.S. at 583; *CTS Corp.*, 481 U.S. at 88. Subjecting non-California corporations to California Section 25400 *and* the laws of the state in which they are properly regulated "create[s] just the kind of competing and interlocking local economic regulation that the Commerce Clause was meant to preclude." *Healy*, 491 U.S. at 337.

2. California Section 25400 Results in an Indirect Violation of the Commerce Clause

California Section 25400 must also be rejected because its nationwide scope violates the Commerce Clause *indirectly*.[22] The majority justifies California Section 25400's impact on interstate commerce by claiming it "regulates only manipulative conduct in California." 19 Cal. 4th at 1063. This ignores the teachings of this court that a state law creates a potentially unconstitutional burden on interstate commerce when it has a "nationwide reach which purports to give [the State] the power" to regulate transactions

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[21] For example, unlike many other states, New York does not allow private civil actions for securities fraud. *See C.P.C. Int'l, Inc. v. McKesson Corp.*, 70 N.Y.2d 268, 275-76 (1987).

[22] A state statute indirectly violates the Commerce Clause when it imposes burdens on interstate commerce which are excessive in relation to the local interests served by the statute. *Pike v. Bruce Church, Inc.*, 397 U.S. 137, 142 (1970); *Edgar*, 457 U.S. at 643; *Healy*, 491 U.S. at 337 n.14; *Terry*, 643 F. Supp. at 165; *Media Products, Inc.*, 158 Ariz. at 467.

occurring outside the state. *Edgar*, 457 U.S. at 643. Given the majority's own proclamation that the statute addresses purported fraud "both in California and throughout the country," California Section 25400 will undoubtedly regulate untold millions of transactions occurring outside of California every year.

V. CONCLUSION

Since California Section 25400's interpretation is an issue of vital importance to federal securities regulation, *Amici Curiae* respectfully request that the Court grant Diamond Multimedia System, Inc. Petition for Certiorari.

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Respectfully submitted,

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